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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1957

No. 330

ARKANSAS-MISSOURI POWER CORPORATION, *Petitioner*

v.

MRS. CLARA K. PASCHAL, ADMINISTRATRIX OF THE ESTATE OF ROY G. PASCHAL, FORMER COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF ARKANSAS; HORACE E. THOMPSON, FORMER COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF ARKANSAS, AND W. D. SELF, ACTING COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF ARKANSAS, *Respondents.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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The Arkansas-Missouri Power Corporation, your Petitioner, prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Eighth Circuit entered in the above entitled case on May 3, 1957.

Citations to Opinions Below

The opinion of the United States District Court for the Eastern District of Arkansas is reported at 144 Federal Supp. 272 (R. 23). The Opinion of the Court of Appeals, (Appendix A hereto, *infra*, pp. 1a-9a) is reported at 243 Fed. 2d 584.

Jurisdiction

The judgment of the Circuit Court of Appeals is dated and was entered on May 3, 1957 (Appendix B hereto, *infra*, p. 10a). On June 3, 1957, the Court of Appeals entered an order denying Petition for Rehearing (Appendix C hereto, *infra*, p. 11a).

The jurisdiction of this Court is invoked under the provisions of Section 1245 (1) Title 28 United States Code.

Question Presented

Where a corporate tax payer, keeping its accounts on the accrual basis, issues its First Mortgage Bonds, Common Stock and Preferred Stock, and with cash and cash scrip exchanges them as a "package" in the reorganization transaction under §§ 77A and 77B of the Bankruptcy Act for property having a fair market value as of the date of the issuance and exchange of said bonds, stock, etc., of $425,181 less than the aggregate market value of the stocks, etc., as of the date of their issuance, plus the par or maturity value of the bonds, does the amount of $425,181 constitute discount on the issuance of the bonds amortizable and deductible for income tax purposes by the tax payer over the life of the bonds?

Statutes and Regulations Involved

The statutes and regulations involved in this case are Section 112(b) (4), Section 112(g) (1)C and Section 113 (a) (7) of the Revenue Code of 1936 (C 690, 49 Stat. 1648), and Section 19.22 (a)-18 of Treasury Regulation 103. The statutes and regulations are set out in Appendix D, *infra*, pp. 12a-13a.

Statement

In a judgment dated May 3, 1957, the United States Courts of Appeals for the Eighth Circuit affirmed a judgment for the respondents entered on July 6, 1956 by the United States District Court for the Eastern District of Arkansas dismissing complaints in a consolidated civil action arising under the Internal Revenue Code of 1939 brought by the Arkansas-Missouri Power Corporation, petitioner herein, against ex-collectors and an acting collector of Internal Revenue for the District of Arkansas seeking the recovery of income and excess profits taxes alleged to have been erroneously and illegally assessed and collected from the petitioner by the said several respondents while in office and acting in their respective official capacities for the taxable years 1939, 1940, 1941, and 1942 (R. 33).

The jurisdiction of the District Court was invoked under § 1340, Title 28, United States Code, and that of the Court of Appeals under § 1291, Title 28, United States Code.

In the District Court, Roy G. Paschal was named defendant and upon his death, the cause of action was timely revived in the name of Clara K. Paschal, Administratrix of the Estate of Roy G. Paschal, deceased (R. 88).

The Opinion of the Court of Appeals and its judgment based thereon dealt with two questions involving substantive income tax issues — first, did the petitioner issue its bonds at a discount? And, second, if the bonds were issued at a discount, is the net amount of such discount amortizable and

deductible for income tax purposes over the life of the bonds?

The Court of Appeals held that if the bonds were issued at a discount, the net amount thereof was amortizable and deductible over the life of the bonds (Appendix A. *infra*, p. 8a). That Court however, held that the bonds were not issued at a discount.

This Petition for Writ of Certiorari is directed to the question involving whether petitioner issued its bonds at a discount.

The following facts are based on findings by the District Court or non-controverted evidence appearing in the record, and were approved by the Court of Appeals.

The petitioner, Arkansas-Missouri Power Corporation, a Delaware corporation, having its principal office and place of business in Blytheville, Arkansas, as of May 1, 1937, pursuant to an order of the United States District Court, Northern District of Illinois, approving a Plan of Reorganization of the Arkansas-Missouri Power Company (hereinafter called the debtor), then in bankruptcy for reorganization under §§ 77A and 77B of the National Bankruptcy Act (C 424, 48 Stat. 912) acquired all of the assets of the debtor, free of liens, except taxes and certain obligations assumed, which assets on the date of acquisition by the petitioner had a fair market value of $4,084,587.60 (F. 21, R. 29[1]).

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[1] F refers to the number of the findings by the District Court and R to the page of the record printed for the use of the Court of Appeals filed herewith.

For these assets as of May 1, 1937, the petitioner paid $83,149.44 cash, issued cash scrip, first mortgage twenty years 5% bonds of the par or maturity value of $2,834,625, 165,805 shares of Common Stock of the par value of $1.00 per share, assigned a book value of $714,460.94, 18.897 1-2 shares of 6% Cumulative Preferred Stock of the par value of $50 per share, aggregating $944,875 (F. 26 and 28, R. 30).

The cash and cash scrip and the bonds and stocks were delivered as a "package" payment for the debtor's assets acquired by the petitioner.

The fair market value on the date aforesaid of the first mortgage bonds was $2,409,444, of the Preferred Stock was $680,313.60 and of the Common Stock was $994,830, making a total aggregate fair market value of the securities of $4,084,587.60 (F. 27, R. 30), exactly the same amount as the fair market value of the asset acquired[2].

On May 1, 1937, the debtor had outstanding the following securities:

First Mortgage Bonds, as follows: $32,000 5%; $3,303,500 6%; $444,020 7%; interest on bonds unpaid from January 1, 1935;

6 1-2% Debentures in the amount of $787,600, interest unpaid from November 1, 1934;

Unsecured Notes $386,500; 12,859 shares 7% Cumulative Preferred Stock of the par value

[2] The intangible properties acquired are listed on Page 60 of the Record and aggregate $1,280,944.99. From this figure is deducted $799,406.99, representing liabilities assumed (R 61). Included in the liabilities assumed was the amount of cash and cash scrip which the petitioner was to pay and issue as a part of the consideration for the property acquired.

of $100 per share; 160,000 shares of Common Stock, par value $1 per share (p. 2, Plan, R. 51).

The petitioner in the years hereinafter set forth called for redemption and retired by payment in cash the par amount of bonds, as follows:

1937 — $25,000; 1938 — $40,660; 1939 — $62,215; 1940 — $2,706,765 (R. 43-44).

The Internal Revenue Service (R. 59), the District Court (F. 23, R. 29) and the Court of Appeals (Appendix A. *infra*, p. 4a) all held that the reorganization as carried out and in connection with which the petitioner acquired the aforesaid assets and issued the aforesaid securities was a taxable reorganization under the income tax laws of the United States.

The petitioner, on its books, valued the assets acquired by it at $4,493,969.94 and treated this amount as the cost thereof, also shown by its books were the sums of $2,834,635 First Mortgage Bonds, Preferred Stock $944,875, Common Stock $714,460.94, or a total of $4,493,969.94 (F. 28, R. 30).

The Internal Revenue Service did not accept as petitioner's tax cost base the amount of $4,493,969.94, and, since the reorganization was taxable, the Service reduced the tax cost base $409,482.34, or to $4,084,587.60 (R. 60), which amount exactly equalled the aggregate fair market value of the assets acquired and also equalled the fair market value of the securities issued and delivered in payment therefor (F. 28, R. 30).

The basic or controlling facts may be summarized as follows:

The fair market value of the lump sum consideration (the debtor's assets) received by petitioner in exchange for its bonds and stocks on May 1, 1937, the effective date of reorganization, was $4,084,587.60; and on said date the fair market values of the bonds, common and preferred stocks were, respectively, $2,409,444, $994,830, $630,313.60.

The ultimate fact to be determined from the foregoing basic facts is: What amount of the lump sum consideration received by the petitioner for all of its securities was received for the bonds?

It has long been the rule universally followed by the Court of Appeals, the District Courts and the Board of Tax Appeals, when confronted with the problem of determining what amount of a lump sum consideration was received for bonds or other debt obligations and stocks, to allocate the lump sum consideration to the several classes of securities on the basis of their respective fair market values. The following cases establish and apply the rule. *American Smelting and Refining Company* v. *United States* (Third Circuit) 130 Fed. 2d 883, involving the issuance of bonds and the payment of cash for Preferred Stock; *Hummel-Ross Fibre Corporation* v. *Commissioner* (Fourth Circuit), 79 Fed. 2d 174, involving the issuance of bonds and stock for cash; *Southern Fertilizer Company* v. *Edwards, Admr.* (U. S. District Court for the Middle District of Georgia), 55-1 USTC § 49-133, involving the payment of cash and the issuance and delivery of new Preferred Stock, scrip and de-

benture bonds in exchange for a lump sum consideration consisting of Preferred Stock; *Natural Gas Pipeline Company* v. *Commissioner*, 45 BTA 939, involving the issuance of bonds and stock in exchange for notes; *Pierce Oil Corporation* v. *Commissioner*, 32 BTA 403, involving the exchange of debentures and common stock for cash.

The application of the allocation formula to the basic facts in the instant case establish as an ultimate fact that the petitioner received for $2,834,625 par or maturity value bonds only $2,409,444 in property — $425,181 less than the par value of the bonds.

The petitioner contends that the $425,181, the difference between the par value of its bonds and the market value of the property received for them, constitutes discount on the issuance of the bonds; and that it is entitled to amortize and deduct such differential as bond discount pro rata over the life of the bonds pursuant to Treasury Regulation 103, Section 19.22(a)-18(3) (a), (Appendix D, *infra*, p. 13a); and that such deduction entitled the petitioner to a reduction of its income and excess profits taxes for the years 1939, 1940, 1941 and 1942 in the respective amounts, to wit: $5,542.73, $51,607.36, $91,244.26, $32,367.87, or a total for all of the years of $180,762.22 (F. 1, R. 23).

The District Court, ignoring in effect its findings of basic facts and the ultimate fact determinable therefrom, held that the bonds were not issued at a discount (R. 38). It apparently took the view that since the bonds were issued in a reorganization transaction under Sections 77A and 77B of the

Bankruptcy Act, they, as a matter of law, could not have been issued at a discount, notwithstanding the fact that the consideration received for them was less than their par or maturity value.

The petitioner appealed the decision of the District Court to the United States Court of Appeals for the Eighth Circuit. On May 3, 1957, the Court of Appeals affirmed the decision of the District Court apparently holding that since the bonds were issued in a reorganization transaction under the said sections of the Bankruptcy Act, they were not issued at a discount, and brushed aside as not applicable the authorities holding that bonds were issued at a discount where the amount received for them was less than their par. The Court of Appeals, however, held that if the bonds had been issued at a discount, the net amount thereof was deductible and should be pro rated or amortized over the life of the bonds (Appendix A, *infra* p. 8a).

Reasons for Granting the Writ

I. The decision below states principles of law directly in conflict with prior decisions of this Court and other Federal Courts.

II. The decision below raises an important question of Federal law which has not been, but should be, settled by the Court.

1. The opinion of the Court below to the effect that petitioner's bonds were not issued at a discount is in direct conflict with a number of decisions of this and other federal courts.

There is no specific statutory allowance in the Internal Revenue Code of 1939 governing bond discount or its deduction. The bond discount deduction as it applies to the years involved is authorized by regulation issued by the Secretary of Treasury, as follows:

> Regulation 103, Section 19.22(a)-18 "Sale and Purchase by Corporation of its Bonds * * * (3) (a) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be pro rated or amortized over the life of the bonds * * *."

The above discount regulation has never laid down a rule for measurement of the amount of the discount. The principle inherent in the regulation is that the necessary balance of the tax structure requires an appropriate recognition as a deduction (or income as the base may be) of any difference between the assets received and the principal amount of debt issued therefor. The regulation has been so construed by this Court in *Helvering* v. *Union P. R. Co.*, 293 U.S. 282, by the Statement (page 287):

> "We think that the revenue acts, as they have been interpreted by this Court and the treasury regulations upon this and related subjects, require that this difference between receipts and disbursements of the tax payer should, in some form, enter into the computation of his taxable income."

The "receipts" in the above statement are, of course, the assets received and the "disbursements" are the principal amount of the debt issued.

Following the decision of this Court in the Union Pacific case, the Court of Appeals of the Third Circuit in the American Smelting Case, *Supra*, held that the difference between the market value of that which was received (in that case Preferred Stock) and the par value of the bonds exchanged for such stock was discount.

The District Courts and Board of Tax Appeals have applied the same principle in numerous cases. *Natural Gas Pipeline Company* v. *Commissioner, Supra; Southern Fertilizer Company* v. *Edwards, Admr., Supra; Industrial Development Corporation* v. *U. S.*, Sec. 72-911, PH Fed. 1956 (District Court, Northern District of Illinois).

The question of what constituted discount was before the District Court of New Jersey in *Montana Power Company* v. *U. S.*, 121 Fed. Supp. 577. In that case the tax payer exchanged debentures for utility property, the fair market value of which was not established. It asserted its claim for discount. The District Court denied recovery on the basis that the tax payer had failed to establish the market value of what was received for the debentures. In the course of its opinion, at page 579, the Court said:

> "We, of course, take it as settled law the principles laid down in both Union Pacific and American Smelting * * * that the amount of the discount is the difference between the par value of the debentures and the fair market value of that which the issuer of the debentures received in return therefor, whether this be cash or property."

The Court of Appeals for the Third Circuit in *Montana Power Company* v. *U. S.* 232, Fed. 2d 511, in a majority opinion, reaffirmed its holding in the *American Smelting Company* case, *Supra*, and held that the difference in the market value of that which is received for an original issue of debt obligations and their par value constituted discount.

The holding of this Court in the *Union Pacific* case, *Supra*, and the holdings of other Federal courts, especially of the Court of Appeals for the Third Circuit in the *American Smelting* case, *Supra*, very definitely established the principle that the difference between what is received for an original issue of bonds and their par value constitutes discount. The facts in the case at bar establish that difference with respect to the bonds here involved. The application of the principles of these authorities to the facts in the case at bar conclusively establish that petitioner issued its bonds at a discount.

Apparently, the Court of Appeals pointed out and relied upon two circumstances which distinguished the facts involved in the cited cases from those involved in the instant case. First, the Court said that the bonds in the instant case "were issued as provided by a Plan of Reorganization under Section 77B of the Bankruptcy Act (30 Stat. 554, as amended) and must provide participation for claims and interest strictly in keeping with their priority." Citing cases to the effect of the quoted language (Appendix A, *infra*, p. 8a).

With due deference, the statement is confusing. Did the Court below mean to say that discount on

the bonds is determined and measured not by the difference in the value received for them and their par value, but by what is due to the holders of the old bonds? If such meaning is attributable to the language of the Court below, it certainly sets up a new and novel principle for determining discount, which pinciple is contrary to the concept of discount expressed by this court in the *Union Pacific* case, *Supra,* and other cases cited above.

The amount due the holders of the old bonds could not possibly in any wise have any place in determining what the petitioner received for its bonds or the difference in such receipts and their par value. To illustrate — suppose the petitioner, instead of exchanging stocks and bonds for the assets acquired, had sold its securities for cash at their respective market values ($4,084,587.60 total) and had paid over that amount of cash to the old company in payment for the assets. Would the manner, the extent and the priorities of the distribution of the cash to the creditors of the old Company have any effect on whether petitioner sold its bonds at a discount? The answer to the question is obvious. It would not have.

Therefore, unless there is something in the Bankruptcy Act or the Internal Revenue Code of 1936 that would require the conclusion that bonds could not be issued at a discount when issued in a transaction in a reorganization under the Bankruptcy Act, the bonds in the instant case were issued at a discount.

There is no language in the Bankruptcy Act or the Revenue Code of 1936 or Treasury Regula-

tions issued thereunder upon which to base such a conclusion and the Court of Appeals failed to point to any provisions of either statute that would coerce such a conclusion.

As to reorganization, the Revenue Code of 1936 contains a series of provisions. The principal objective accomplished by these provisions was to classify reorganizations into taxable and non-taxable categories. The provisions referred to are set forth in Sections 112 and 113 of the Revenue Code of 1936, Chapter 690, 39 Stat. 1648. The pertinent parts of these sections are set forth in Appendix D, *infra*, pp. 12a-13a).

The provisions make no distinction between voluntary reorganizations and those growing out of bankruptcy proceedings. The application of these sections to the facts in the instant case resulted in classifying the reorganization here involved as taxable.

The conflict between the holding of the Court of Appeals in the instant case, to the effect that petitioner's bonds were not issued at a discount, and the holding of the Court of Appeals in the *American Smelting* case, *Supra*, and of the several district courts and the Board of Tax Appeals cannot be erased in the manner attempted by the Court of Appeals. The conflict remains, notwithstanding the statement by the Court below:

> "Suffice it to say that the cited cases are distinguishable upon their facts." (Appendix A, *infra*, p. 9a.)

Another statement contained in the opinion of the Court below that may have formed a basis for the distinction which it attempted to make between the facts of the cited cases and those in the instant case is:

> "We are of the opinion that selling the bonds on the open market for 85 cents on the dollar has no bearing on whether the bonds were issued and paid for at par under the record of this case. Nor do the facts in that connection support taxpayer's claim of a deductible discount" (Appendix A, *infra*, pp. 8a-9a).

This reference indicates the confusion of the Court below as to the basis of petitioner's claim of discount. Its claim was based not on the market value of the bonds, but upon the fact that the fair market value of that which was received for them was less than their maturity value. The only use made of the market value of the bonds was in the allocation of the lump sum consideration received for the stocks and bonds to the several classes of securities. Furthermore, the market value of the bonds is a check against, but does not fix, the value of what was received for them. *American Smelting & Refining Co.* v. *U. S.*, *Supra*, page 886.

It has long been the rule that the market value of the debt obligations issued for property is not sufficient to establish that the obligations were issued at a discount. See *Kansas City Southern Ry. Co.* v. *Commissioner*, 22 BTA 949; *Southern R. Co.* v. *Commissioner*, 27 BTA 673; *New York C & St. L. R. Co.* v. *Commissioner*, 23 BTA 177, aff'd. 64 Fed. 2d 152.

Before an apparent conflict between two decisions can be erased or explained away, there must be present a resonable basis as well as a lawful basis for distinguishing them. The conflict between the decisions of the Court of Appeals in the instant case and the cases cited and discussed is real and remains, notwithstanding the attempt of the Court below to justify or explain such conflict.

2. The decision below raises two important questions of federal income and excess profit tax law which have not been, but should be, settled by this Court. The questions are:

(a) Does recognizable discount under Treasury Regulation 103, Sec. 19.22(a)-18 (Appendix D, *infra*, p. 13a) arise out of a transaction where on an original issue of debt obligations are exchanged for property, other than cash, having a fair market value less than the maturity value of the obligations?

(b) Assuming an affirmative answer to the question posed in (a) above, would recognizable discount arise in a transaction in reorganization under Sections 77A and 77B of the Bankruptcy Act, if the facts and results were the same as those stated in (a) above?

Both questions are novel and of first impression in this Court. In fact, the Court below is the first to be confronted with the second question.

The refusal of the Court below to follow the authorities which, if applied to the facts in the instant case, would give rise to discount not only creates a conflict between decisions of two courts of

appeals and is contrary to the decision of this Court, but casts considerable doubt on whether discount can ever arise where debt obligations are exchanged for property.

Moreover, in the case at bar, the Internal Revenue Service established a new tax cost base for the assets acquired by the Petitioner. This base was imposed by the Revenue Act. An inequitable result may be reached and an integrated tax structure upset if the decision of the Court is permitted to stand. *See Sacramento Medico Dental Bldg. Co.* v. *Commissioner* 47 BTA 315.

The basis for issuance of the Writ herein asked for may be summarized, as follows:

(1) The questions presented (*Supra*, p. 17) are before this Court for the first time;

(2) They involve an important area of income tax jurisprudence not covered by statute, but governed wholly by administrative regulation and, more importantly, judicial interpretation;

(3) There is no unanimity among courts and judges as to whether discount may arise on the issuance and exchange of bonds for property other than cash (see Concurring Opinion by Judges Kaldner and Staley in *Montana Power Company* v. *U. S.* 232 F. 2d 511, 515, and the Opinion of the District court in the instant case, (R 31, 35);

(4) The decision below injects into the application of the Treasury Regulation a new and novel concept of discount on the issue of bonds, *i. e.*, discount is not measured by the difference between the market value of the assets the issuer receives

for his bonds and the par value thereof, but by the difference in the amount and priority of a creditor's claim against said assets and the par value of the bonds issued therefor;

(5) The decision below creates more confusion and broadens the area of conflict involving basic principles in the application of the tax law.

The foregoing facts are considerations calling for a clarification essential to a proper and uniform application of the income tax law.

CONCLUSION

The decision of the Court below is in hopeless conflict with the decisions of this and other courts. Furthermore, important questions have been raised by said decision which have not been, but should be, settled by this Court. The Petition for the Writ of Certiorari should, therefore, be granted.

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